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Lies, Damned Lies, and Statistics

> **"Where economic growth is slow and calm, crises are less noticeable and very short; where it is rapid or feverish, violent and deep depressions upset all business for a time. It is necessary to choose one or the other of these conditions, and the latter, in spite of the risks which accompany it, still appears the more favorable."**
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> ***Des Crises Commerciales et de leur Retour Périodique en France, en Agleterre et aux Etats Unis***
> **Clément Juglar, 1889**

Easy money remains the bullish watchword, as Wall Street looks forward to another year of sluggish growth and low inflation. Like Pangloss, the speculators tend to their gardens, confident that this is indeed the best of all possible worlds.

We can hardly quarrel with the prevailing forecast of slow growth. This has been our own prediction for some time. Yet where the consensus sees healthy economic fundamentals, we see a persistent, secular stagnation, the legacy of years of excessive credit creation, fiscal profligacy and chronic overconsumption.

The true threat to the prevailing euphoria, we should stress, is not to be found in the remote possibility of a synchronized global recovery, bringing with it inflation and monetary tightening. The current business cycle – never robust – already is far past its peak. The most powerful evidence for this can be found in the United States, where consumer borrowing and spending both stalled during the course of 1996.

Given the role of debt-financed consumption in powering the U.S. expansion, it seems inevitable that business investment also will falter in 1997. The catalyst, we suspect, will be the looming debacle in corporate profits.

As we have explained in past letters, the unique factors that drove double-digit profits gains during the early 1990s have faded from the scene. Under the best circumstances, earnings growth must decelerate to a rate more consistent with GDP growth. But if a slowing economy also brings a collapse in revenue growth, even that modest scenario may prove unrealistic. Either way, Wall Street's outsized earnings expectations are doomed to disappointment.

This bearish reckoning has been postponed by the latest economic figures, showing a sizable uptick in U.S. GDP growth in the fourth quarter. However, as we explain, a closer examination of the numbers reveals significant exaggerations in the underlying growth trend. In particular, suggestions of a U.S. export boom – which have helped buoy the dollar's winter rally – almost certainly are the product of long-standing seasonal distortions. Given the recent deterioration in Japan, Continental Europe and Southeast Asia, it is absurd to hope for export-led U.S. growth in 1997. Indeed, subpar growth in the United States could be the signal for recession in those economies.

Slower U.S. growth – implying Fed easing instead of Fed tightening – is likely to cap, if not reverse, the dollar's rise. This will put additional pressure on the central banks of the Asian Tiger countries, who have assumed from the Bank of Japan the burden of supporting the greenback with massive official purchases. For the Tigers, at least, easy money is having its traditional effects: economic overheating and inflation. How those ills affect their willingness to shore up the dollar could prove a critical, if unexpected, variable in the 1997 economic equation.

LOOSE MONEY AHEAD

Looking into 1997, the safest thing to say is that loose money will persist in the industrial countries, becoming virtually a permanent feature. As economic growth is being retarded by structural maladjustments resulting from past excesses, monetary policy has to stay in overdrive. But the effects are grossly disproportionate. While the real economies respond sluggishly, financial markets are hyper-stimulated.

Earlier expectations that world economic growth would accelerate into a synchronized, robust recovery have been shaken by news of the deteriorating situation in Japan and Continental Europe. Yet, reading many different forecasts, it appears to us that in general their narrative text remains rather more upbeat than can be justified by the underlying statistical data.

The OECD 1997 Economic Outlook is a case in point. It begins with just such a promising statement: "The convergence of cyclical conditions in the OECD area is likely to continue in the coming year, with robust and sustainable growth in the United States and a continuation of the expansions in Japan and Europe, following a pause in 1996." Yet in the statistical table for that same report, the OECD projects for its member countries exactly the same 2.4% annual growth rate as last year.

In other words: The expansion is fully expected to follow the rosy "Goldilocks" pattern, as it has been labeled on Wall Street. In the words of the fairy tale, the economic porridge will be "not too hot, and not too cold, but just right." More precisely, protracted, sluggish global growth will continue to accompany inflation rates that are the lowest in the past thirty years – and still falling. But for Wall Street the true bottom line is that global monetary policy will retain its extremely easy stance for as far as the eye can see.

A recent report from Goldman Sachs characterizes the Goldilocks scenario this way: "The healthy picture for world growth is predicated mainly on the stance of global monetary policy, which we deem abnormally easy. Although this is still debated by some analysts in different parts of the world, such a conclusion seems to us inescapable for the OECD as a whole. Easy money is indicated not just by the level of short and long-term real interest rates around the world, but it is also suggested by the shapes of the yield curves, the behavior of equity prices, the accelerating growth in real broad money, and the collapse of credit spreads in many bond markets. The exceptionally strong performance by most high-yielding assets this year is itself powerful evidence of expansionary conditions."

We could underline every single word in that statement, except one: "healthy." By definition, abnormal monetary ease cannot have truly healthy effects. Essentially, it must fuel speculative excesses and cause economic distortions. Actually, all of the symptoms mentioned by Goldman Sachs are proofs of a speculative bubble. The crucial phenomenon underlying the global financial boom is the persistent failure of protracted, abnormal monetary ease to kindle stronger business cycles and economic growth. Instead, it overstimulates the financial markets and stokes the speculative frenzy. That is the logic of this development.

Speculative bubbles typically are pricked by monetary tightening. But we have to consider the possibility that the persistent trend of global economic sluggishness will perpetuate monetary looseness and low inflation for years to come. Whether or not this should be called deflation, or the more benign-sounding "disinflation," is a question of semantics. Actually, the consensus forecast for 1997 promises more of the same: sustained but subdued economic growth and no significant inflationary pressures. Any surprises are expected to be on the upside.

We, too, subscribe to a forecast of economic sluggishness, but with an important difference. It is our long-held opinion that the global business cycle of the 1990s is far more vulnerable than robust. The booming financial markets are mistakenly seen as a sign of economic health. Yet precisely the opposite is true. They are symptoms of the extreme imbalances that continue to plague the major economies. Therefore, any economic surprises in 1997

almost certainly will be on the down side, not only in Japan and Continental Europe but also in the United States and Britain. This implies that the global business cycle not only paused in 1996. Most probably, it also has played itself out.

Those who expect renewed global strength in 1997 count primarily on the stimulative power of the progressive monetary loosening that has taken place over the past several years outside the United States. Our focus, by contrast, is on the investment cycle, both in inventories and in fixed capital. This cycle – which reflects the most dynamic components of GDP – quite obviously has peaked.

Aggressive monetary easing did result in real GDP growth in the OECD area of 2.8% in 1994, after a meager 1% in 1993. But the chief source of this recovery was fixed investment and inventory building, associated with a strong expansion in industrial production, averaging 5-6%. These sources of growth already have subsided.

Indeed, compared to past global business cycles, the present one had an unusually weak start. Worse still, the first year proved also to be the crest for global growth, which immediately relapsed in the following year. What boomed instead – and all the more – were the financial markets.

CACOPHONY AND CONFUSION

Our chief disagreement with the market consensus is about the strength of the U.S. economy. Another of our long-held views is that the economics profession in the United States suffers from an excessive supply of relevant and irrelevant economic data that confuses more than it informs. The markets constantly are roiled by a cacophony of conflicting statistics. Signs of strength rapidly alternate with signs of slowdown. This obscures the fact that the trend in the decisive economic fundamentals clearly is tilted to the down side.

Last year, economic growth proved disappointing in many countries, mainly in Europe and in the Far East excluding Japan. In the case of the United States, activity in the third quarter came in considerably weaker than expected, depressed by near-stagnant consumer spending. Was this a durable or just a transitory slowdown? That was and still is the big question concerning the U.S. economy.

As already mentioned, most economists forecasting firming global GDP growth are betting on extraordinary monetary looseness and on the behavior of such financial variables as steep yield curves and extremely bullish stock markets. Admittedly, these conditions appear more expansionary than ever before. In the past, they certainly would have fueled booming economies. But, under the grossly abnormal economic conditions of today, past experience has little or no relevance.

Rather, we must ask ourselves why so many economies slowed down last year despite the heavy monetary and financial tail winds behind them. We find the failure of monetary ease to kindle sustained growth extremely troubling, given that with interest rates as low as they are in many countries, there is very little room for further easing.

In our view, the main risks to a renewed upswing of the U.S. economy in 1997 are disappointing consumer spending and subpar business profits, which also would tend to depress investment spending. These two demand components have propelled the cyclical upswing since 1992, accounting for all of total U.S. economic growth during that period.

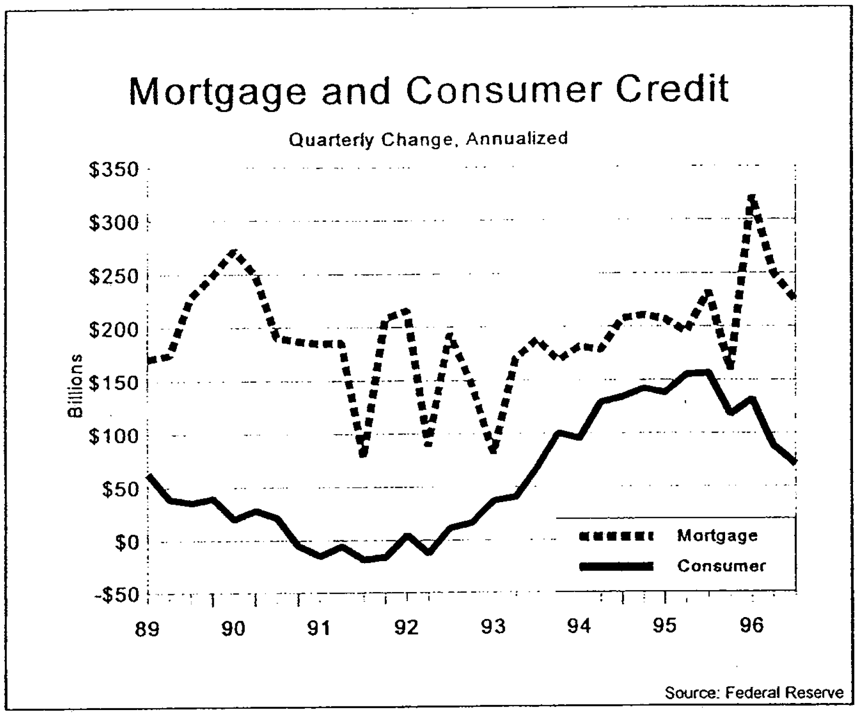
But, after sharply accelerating in the first half of last year, U.S. consumer spending suddenly relapsed in the third quarter to near-stagnation. Perhaps the most important task facing the stock, bond and currency markets is to determine the cause of this setback to consumer spending. Consider the dollar's recent surge on the back of news

seeming to suggest a revival in U.S. economic growth: Is that picture true, or just a mirage? That's why the indicators of final consumer demand need most careful monitoring.

Though the sudden third-quarter pause in consumer spending took everybody by surprise, it was widely discarded as an aberration. The general argument has been that the trends in the key consumer fundamentals – employment, income, confidence, wealth and savings – simply are too strong to validate a lasting downturn in spending.

CREDIT WATCH

Taking a closer look at the underlying data, we must conclude that there is much more to the third-quarter lull than just a random pause. The slowdown in demand growth during the past year has been more broadly based and enduring than generally has been perceived. To us, what is particularly significant is the fact that, adjusted for inflation, total consumer spending was completely flat between May and September, while real retail sales have been stagnant since last February, despite heavy discounting. Focusing on the trends behind the erratic monthly numbers, we see that auto sales as well as housing both are quite soft. Any gains in consumer demand have been confined to services, above all to the booming financial-services sector.



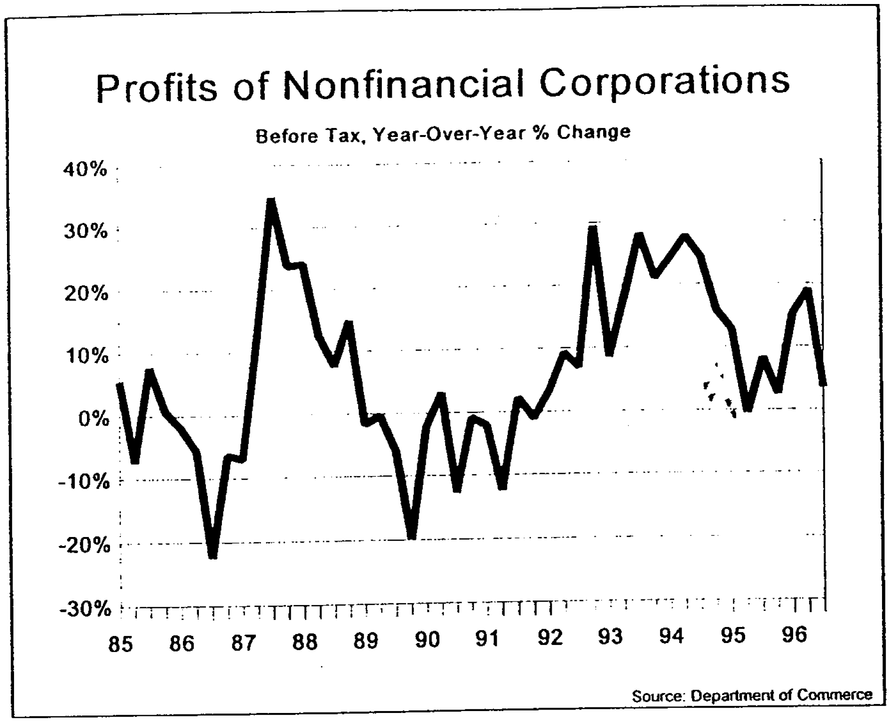
In our view, there is a natural and most plausible explanation for this sluggishness in spending: The consumer borrowing binge since 1992 has exhausted pent-up demand. By implication, borrowing for the purchase of consumer durables is the major cyclical component in the consumption sphere. Credit is the evident key variable between income and spending'

To be sure, American households have borrowed with a vengeance, with consumer-credit growth exceeding income growth year after year by a wide margin during the present recovery. Between 1991 and 1996, U.S. private household income growth of $1.48 trillion compared with simultaneous total debt growth of $1.68 trillion. Conspicuously, the most expensive debt category – installment debt – soared fastest, with a cumulative increase of nearly $400 billion, or 50%. It's hard to believe that those who tap this source are great beneficiaries of the wealth effect from the booming stock market.

Considering these big debt numbers, it is patently clear that consumer borrowing has been crucial in fueling the present U.S. economic recovery. Growth in installment credit skyrocketed from a minuscule $5 billion in 1992 to an annual rate of $156 billion in third quarter 1995. New mortgage borrowing rose from $161 billion in 1992 to a peak in first quarter 1996 of $322 billion, also at an annual rate.

But the growth rate of both aggregates since has plunged. In the third quarter of 1996, installment debt grew by just $70 billion and home mortgages by $223 billion, again both at annual rates.

Is the recent weakness in consumer spending for real? In light of the plunge in consumer borrowing, we would say yes. Certainly, this appears far more plausible to us than the opposite theory, which views it as a temporary pause. If consumer demand fails to rebound strongly, this implies a corresponding decline in the growth of U.S. employment and income, including business profits.



FROM PROFIT MIRAGE . . .

The other aggregate of overriding importance for any economy's performance, of course, is the trend in business profits, which exerts a high leverage both on investment spending and stock prices. Exceptionally strong profit gains have been a hallmark of the current U.S. expansion. Since the last recession ended in 1991, corporate earnings have soared nearly 68% – more than twice the nominal growth rate of the U.S. economy as a whole. This profits boom had it corollaries in surging business investment expenditures and in ballooning stock prices, which more than doubled during this period.

Yet the thing to realize is that the profits boom is over. In hindsight, the turning point can be found in the fourth quarter of 1994. In that quarter, before-tax profits of nonfarm, nonfinancial corporate business ran at a $400.8 billion annual rate. They reached a $418.6 billion annual rate in the third quarter of 1996. In other words, for the entire seven quarters, profits showed a total increase of just 4.4%, considerably *less* than GDP growth. Apart from moderate profits gains in the first half of 1996, there has been near stagnation. Only financial corporations have managed to maintain profits momentum.

In various letters last year, we warned of an impending, drastic profits slowdown. As to the facts, we were perfectly right. But what we completely misjudged was the impact on the U.S. stock market. Not only has the profit reversal been flatly ignored, but the rise in stock prices actually has speeded up, with the Dow Jones Industrial Average rising nearly 78% since the end of 1994.

The essence of our detailed analysis is the fact that – contrary to the prevailing perceptions – U.S. corporate profits in the 1990s not only have not overperformed, they actually have grossly underperformed past business cycles.

Wall Street propagandists have argued that the phenomenal profits boom had its primary source in the corporate restructuring craze, which supposedly boosted productivity and profitability. We have shown that this is simply a myth. The share of labor costs in total business costs did not decline in the early 1990s. What plunged were corporate net interest expenses. Smaller windfall gains also accrued from lower taxes and from sluggish growth in depreciation charges, reflecting the near collapse of U.S. business investment in the late 1980s.

The bottom line: Adjusted for interest costs, taxes and depreciation, corporate profits growth in this economic expansion has been appreciably weaker than in the three previous cycles. Special factors created a temporary profits

mirage. The long-term trend is down, not up. We realize this statement is sure to meet with widespread disbelief and dissent, but it tallies perfectly with the official labor statistics, which show strong U.S. employment growth, continued meager productivity growth and rising wage rates.

Indicators of U.S. Inflation

Annual Percentage Change

	1993	1994	1995	1996
Compensation Per Man Hour	2.3%	2.1%	3.2%	3.7%
Labor Productivity	0.2%	0.5%	0.1%	0.7%
Unit Labor Costs	2.3%	1.4%	3.0%	2.9%
Producer Prices	0.9%	0.6%	1.9%	2.6%
Consumer Prices	2.7%	2.7%	2.5%	3.3%

Source: Economic Indicators, Council of Economic Advisors

The figures shown here pinpoint the U.S. economy's profits and inflation problems. It's not a particularly attractive picture. Comparing the dismal rise in productivity with the rise in prices, it's clear inflation remains the main source of business profitability. Since 1992, the U.S. economy's overall productivity gain has been a paltry 1.8% – the lowest of all times. As average hourly compensation increased nearly 13% during that same period, unit labor costs jumped by 10.5%. While it is customary on Wall Street to cheer the sharp decline in inflation since the 1980s, it shouldn't be overlooked that U.S. inflation rates today still are among the highest in the industrialized world.

In any case, as we explained, the new important fact is that profit growth in the nonfinancial sector has faltered badly. Yet stock prices have skyrocketed faster than ever. In the manic phase, the market typically detaches itself from reasonable valuation measures. The only thing that counts is the expectation of a continuing upward move.

. . . TO PROFIT MANIPULATION

Nevertheless, we think the current euphoria stems from more than just investor mania. Wall Street and the corporate world have demonstrated unparalleled ingenuity in producing "better-than-expected" earnings to help perpetuate the boom. As corporate productivity generally has deteriorated, it has required ever more creativity to support ever more exorbitant stock prices. From accounting tricks to earnings forecasts, there is systematic delusion.

The use of charge offs has become an accepted practice to obscure earnings trends. At the same time, Wall Street analysts have become almost completely devoted to the single goal of raising stock prices. Most appear to have lost all objectivity – as seen in their carefully timed changes to earnings forecasts, ratings upgrades, and relentlessly favorable comments. Since the market focuses almost entirely on the difference between reported and expected profits, it has become a customary game for analysts – with company guidance – to cut their earnings forecasts to levels low enough to put even falling profits into a positive light, once the actual figures are released.

That's hard stuff, to be sure. But it can be substantiated by looking at the balance sheets and earnings reports of two exemplary cases: IBM and General Electric. Both are bellwethers for the U.S. economy and the stock market. In fact, if there is one company that symbolizes the perceived U.S. business renaissance, it is IBM. As the story goes, IBM is now on the road to rising profitability through technological development and cost-cutting efficiencies.

Remember, at the end of 1990, the market value of IBM was only slightly more than $38 billion, as against today's $80 billion, even though earnings per share were then a bit higher. After several years of dreadful results and massive write-offs, the company's market capitalization fell to $20 billion. Unable to grow their stagnant core businesses, IBM managers made several acquisitions, the largest one being the $3.2 billion purchase of Lotus, the struggling software maker. As a result of the deal, liberal accounting rules allowed IBM to take a $1.8 billion write down of "purchased in-process R&D." This reduced future expenses and inflated reported profits.

To boost earnings per share and the price of its stock, IBM also became a heavy buyer of its own shares. After spending almost $4.9 billion in 1995, it bought another $5.8 billion worth of shares in 1996, $1.9 billion in the fourth quarter alone. This certainly contributed to last year's breathtaking gain of 30% in IBM stock. But shareholders' outstanding equity ended 1996 at $21.6 billion – 43% lower than in 1990. Fourth-quarter sales were less than 1% higher than in 1990's fourth quarter. All in all, it has been a formidable display of corporate leveraging.

Counting IBM's quarterly losses and profits since fourth quarter 1989, we see the company had total profits of $23.7 billion, and total losses of $20.4 billion. In other words, IBM has made virtually no money in the past seven years. But, because Wall Street treats write offs as such great positives, this fact has hardly been noticed.

Elsewhere, Wall Street and the media recently celebrated the latest earnings release from General Electric, dubbing the company the most profitable in American history. Quarterly earnings surpassed $2 billion for the first time. Earnings per share grew 13% from 1995's fourth quarter. Long hailed as Wall Street's chosen role model for sustained earnings growth, GE has seen investors award it a market capitalization of $168 billion, a price-earnings ratio of 23, a price-to-book ratio of 5.59, and a remarkable 2.5 price-to-revenues ratio.

While we will not argue about GE management's proven ability to grow earnings, we do dispute Wall Street's claim that the company's performance is proof of American industrial competitiveness. In our eyes, it actually exemplifies a shift in corporate activity from production to financial services and speculation. Obviously, GE finds it much more tenable to provide Wall Street's desired earnings growth through financial activity rather than by producing goods.

Because GE has not yet released details of its fourth-quarter books, we have used third-quarter data for our analysis. We note that GE's balance sheet grew by $21 billion in the first nine months of 1996 – to $249 billion. But property, plant and equipment (PPE) accounted for only $28 billion, or 11%, of total assets. Excluding assets from the company's GE Capital subsidiary, net PPE reached just over $10 billion, a scant $162 million increase. GE Capital's total assets, meanwhile, increased by no less than $18.6 billion.

STRONG OR SLUGGISH GROWTH?

The biggest surprise for us – as for many others – since the start of the year has been the dollar's sharp rally. Apparently, it has been driven by a confluence of several events:

- Unexpected strength in the U.S. year-end economic data, combined with signs of an overheating labor market, shifted market expectations anew from an impeding rate cut to a rate hike by the Fed.

- Sharply worsening sentiment on Japan's economic recovery has made it clear that a tightening by the Bank of Japan is a long way off.

- Downbeat news about the German and European economies is supposed to imply pressure for more monetary easing by the Bundesbank and the continent's other major central banks.

The other bullish factors, of course, are the continuing large dollar purchases by foreign central banks and the steady jawboning of Treasury Secretary Robert Rubin and officials in Japan and Europe, who take every opportunity to stress the desirability of a strong dollar. But neither of these factors is anything new.

As expected, U.S. real GDP growth for the fourth quarter of 1996 accelerated sharply, reaching a 4.7% annual rate, compared to 2.1% in the third quarter. For the consensus, this has been enough to dispel the earlier, widespread prediction of a consumer-led economic slowdown. After taking a closer look at the numbers, we disagree.

The new euphoria about U.S. economic growth started in early December with reports of a buoyant kickoff to the Christmas shopping season, soaring consumer confidence, growing business optimism and another bullish run on Wall Street. But final holiday sales results proved rather disappointing. Fourth-quarter real retail sales did come in somewhat stronger than expected, at a 1.5% annual rate, compared to 1.3% in the third quarter. Yet it was the weakest Christmas quarter since the recession year of 1991. Even last year, when disappointment with holiday sales was quite widespread, retail spending managed a 2.2% fourth-quarter gain.

Actually, the surge in fourth-quarter GDP was presaged by a single piece of news: the November trade numbers. Owing to plunging deficits with China, Japan and the OPEC countries, the overall U.S. trade deficit for that month remained surprisingly low, following an already low October reading. Together, the figures for the two months suggested a trade improvement in the fourth quarter of $8-9 billion. Not a big deal, really, but the customary annualization of the quarterly GDP data blew it up to a $37 billion gain in U.S. net exports, enough to add a bit more than 2% to fourth-quarter GDP growth.

There is every reason to discard this trade-related boost to GDP as a statistical fluke. For one thing, there is a well-established pattern of U.S. trade flip-flops in the second half of the year, pointing to a faulty seasonal adjustment. Next, the annualization of all quarterly GDP data – implying that every figure is multiplied by four – inflates any minor distortion into a capital error. That is one reason why the United States is the only country in the world to make such wide use of annualizing.

In any case, there is another, bigger snag. As is officially admitted, U.S. economic statistics are a woeful mess. In the third quarter of 1996, gross domestic income calculations inexplicably exceeded gross domestic output calculations by nearly $100 billion. In principle, the two ought to be exactly equal, as incomes arise from output. But, owing to last winter's prolonged government shutdown, regular benchmark revisions have been skipped. The big question now is how much of the huge error is due to grossly overstated incomes and profits, and how much is due to faulty estimates for investment, inventories, the trade deficit and other items.

OUR VIEW: THE U.S. ECONOMY IS SLOWING

Some commentators claim the statistical error in the national-income accounts reflects a sizable understatement of GDP growth, one that eventually will be revised upward. More probably, the errors are on both sides of the equation. Output and spending may be somewhat understated and therefore due for an upward revision, while incomes and profits are in for a considerable downward revision. In the end, profits may well emerge as the main victim.

In trying to determine the U.S. economy's future course, we prefer to focus on the trends in a few aggregates which we believe to be of strategic importance. The crucial ingredient in the current U.S. expansion has been the explosive rise in consumer-installment credit, combined with an explosive rise in business profits, which has fueled a surge of investment in new business equipment. Both of these trends peaked in late 1994.

In the consensus view, the sharp slowdown of consumer spending in the third quarter of last year was an aberration that can't persist, given the excellent financial fundamentals for consumers, including job growth, income growth, consumer confidence and the tremendous positive wealth effects from the surging stock market. In our view, the more important reality affecting the consumer is the prolonged plunge in the rate of personal loan growth, which hit in the fourth quarter a new low of 2.6%, annualized, down from 6.5% in the third quarter.

Another foreseeable drag on U.S. economic growth in coming months will be the slowdown in inventory building. During the second half of 1996, an acceleration in inventory accumulation prevented the deceleration in consumer spending from adversely impacting output and employment. This will not be the case in 1997.

In sum, we are sticking to our expectation of slower U.S. economic growth in the coming year, and accordingly to our conclusion that the Fed's next move will be a rate cut, rather than a rate hike. The one thing that would change our mind on this score would be a revival of the consumer-borrowing binge. While always possible, given the recklessness of the American consumer and the American credit system, we regard it as highly unlikely, given the already stretched condition of household balance sheets.

STOCK MARKET WATCH

More importantly, how will this turn of affairs affect the financial markets? The ready answer is that it will tend to buoy both stocks and bonds. Sluggish economic growth and easy money remain Wall Street's pipe dream.

But having said that, we must hasten to add our qualifications. While we see a weakening U.S. economy perpetuating easy money, the huge speculative imbalances in the stock and bond markets clearly make anything possible. Focusing on the stock market, we wonder whether deteriorating profits finally will lead to a bursting of the bubble. Or will another buying stampede finally exhaust this aging bull market? It is impossible to say. But we do know that the market's recent euphoria is absurdly out of line with weak profit growth and higher bond yields.

As we try to make sense of the increasingly chaotic nature of stock trading, we are reminded of how wildly speculative the credit markets became in the late summer and fall of 1993. Huge speculative plays were made in the bond futures markets by hedge funds and other speculators, until growing market distortions caused a massive unwinding of leveraged positions in an environment dominated by market-neutral and derivatives strategy. It seems to us that the stock market now has reached a similar point, as huge speculative bets concentrated in the S&P futures market have powered stocks to new highs, while a select group of Nasdaq stocks have run to even more unbelievable levels. The fuel for these upward moves is easy to find: Every piece of positive news leads to panic short covering by big players running sophisticated hedging strategies.

HOT MONEY RULES BONDS

To make a reasonable forecast now for the U.S. bond market is no less daunting and frustrating than attempting to predict the future direction of stock prices. On the buyer's side, there is literally nothing that resembles financial normality. It has been calculated that foreign parties purchased 154% of all new U.S. debt securities issued in 1996, including both first-issue and secondary trading. This implies that domestic investors have been heavy net sellers of bonds. The last time this happened was in 1974.

Given the fact that U.S. longer-term bond yields today are among the highest in the world, it seems self-evident this should attract foreign money. But oddly, ordinary foreign private investors have accounted for the smallest part of the enormous capital inflow. Most of the foreign buying has come from two extraordinary groups. One is the small number of foreign central banks who run sizable payments surpluses with the United States. The other is the community of offshore hedge-fund traders, mostly domiciled – for tax purposes, at least – in the United Kingdom or in the tax-haven countries of the Caribbean. In reality, these typically are fronts for U.S.-based investors. To that extent, foreign buying actually is camouflaged domestic buying.

But if the lack of private foreign interest in U.S. bonds is remarkable, far more remarkable is the literal absence of foreign investors from the booming U.S. stock market. From January to July 1996, foreign net purchases of U.S. shares were a paltry $7.7 billion, following an even more modest $11.2 billion in 1995. Apparently, foreigners generally don't trust the U.S. market.

The chief ploy of the hedge funds playing the U.S. bond market is well known. They finance highly leveraged positions in Treasuries with yen borrowed at little more than 0.5%. With this "yen carry trade," they net the wide

5-6% spread between short-term yen interest rates and intermediate Treasury yields. In addition, they have benefited from the dollar's substantial appreciation against the yen - which they themselves have helped cause. Indeed, Japan presently is of great importance for the international bond market not owing to Japanese investors, but exclusively owing to the yen carry trade. Japanese buying of U.S. bonds literally has dried up.

Considering the overriding influence of these exotic demand sources, U.S. long-term rates obviously are skewed to the down side. Without the massive purchases of foreign central banks and hedge-fund speculators, U.S. rates would be much higher. Forecasting U.S. rates, then, boils down to the question: Will these purchases continue?

As to the central banks, their buying spree in U.S. Treasuries is a by-product of their exchange-rate policies. In practice, all of these purchases lately have been made by Asian central banks, not including Japan. Given the plunge in their exports in 1996, and the steep depreciation of the yen, these countries are desperate to prevent their currencies from rising against the dollar, which also has been pulling them up against the yen. Hence their furious accumulation of dollar reserves, which promptly are invested in short-term U.S. Treasuries.

As a consequence of this massive reserve accumulation, the Asian Tiger countries all face – to a greater or lesser degree – Japanese-style economic ills: excessive credit and money creation associated with gross overinvestment in industrial capacity and property. Yet there is a crucial difference with Japan that makes these countries highly vulnerable to an external shock. Japan's dollar glut accrued from its chronic, huge trade surplus. But for most of the Asian Tigers, their excess dollar holdings stem from inflows of portfolio capital and short-term money vastly exceeding their current-account deficits. In other words, it's hot money that the Tiger central banks are recycling into Treasury bonds. The decisive imponderable, then, is the sustainability of these underlying hot-money flows.

An immediate potential for trouble looms in South Korea and Thailand, owing to their widespread banking and debt problems. Just to illustrate the nature and size of these problems: Since 1990, Korea's currency reserves have soared from $15 billion to $32 billion, while its current-account deficit has exploded from $2 billion to $23 billion. Admittedly, Korea is an extreme case, but to a lesser degree all countries in the region are struggling with the same problems, implying the impending end of their Treasury buying, if not outright future selling. Most lately, the sole big buyer of Treasuries has been the central bank of the People's Republic of China.

And the leveraged carry trade? In essence, it, too, is a species of hot money exposed to two risks: U.S. monetary tightening bringing rising U.S. bond yields, and a rise in the yen. Either of the two events would trigger the unloading of huge leveraged bond positions on a scale that surely would play havoc with the markets. Neither appears likely in the foreseeable future. Still, one day the yen is bound to recover from its present lows.

EURO WRANGLE

Leveraged speculation in bonds is by no means limited to the U.S. market. It is in heavy use around the world, although to different degrees. While there is no statistical evidence, there is every reason to assume this game is being played most intensely in the high-yielding currencies. The higher the interest-rate differential, the more lucrative the practice of borrowing in currencies with the lowest short-term interest rates – yen and Swiss francs.

In Europe, the dominating topic in 1997 will be European Monetary Union. Will it be implemented punctually? The criteria for entry into the first stage of EMU on January 1, 1999 must be met this year. If we assume that for the politicians the timetable is more important than the criteria themselves, we can say that bond markets have carried the yield-convergence game to excess, squeezing the formerly sizable interest-rate differentials among the EU currencies nearly out of existence. The once formidable 10-year spread between the DM and the Italian lira is down to about 130 basis points, while the spread between the DM and the Spanish peseta is only 90 basis points.

We share the general view that Europe's politicians, including in the first place Chancellor Kohl, will do everything in their power to implement EMU, at least among the core countries, regardless of whether the two key critical fiscal criteria are met. When Gerhard Schröder, the Social Democratic Prime Minister of Lower Saxonia and a leading contender for the chancellorship in 1998, recently dared to say in public that EMU should only be started when the conditions are satisfied, he came under vituperative attack from all sides – even though this basically is the government's own official position.

Still, we maintain our view that the criteria laid down in the Maastricht Treaty cannot be violated too flagrantly because EMU could then be rejected by Germany's Constitutional Court. The fact that 1998 is an election year in Germany also argues against excessive cheating.

In light of those considerations, the markets' benevolence towards Italian bonds is starting to defy comprehension. Budget-cutting plans for 1996 are in shambles. Instead of shrinking, the Italian deficit has increased to 7.5% of GDP, nearly 1.6 percentage points above target.

Meanwhile, the Kohl government has revised its own budget-deficit estimates upward, from 2.5% to 2.9% of GDP. The new number was not picked lightly – it is a hair's breadth within the 3% limit specified in the Maastricht Treaty. But in reality, even this new deficit projection is unrealistic. It assumes German economic growth will pick up from 1.4% in 1996 to 2.5% this year. We are sure France and the other potential EMU candidates will join Germany in fiscal failure, albeit one they will attempt to fudge.

Our doubts that EMU will materialize have sharply increased in recent weeks. For one thing, the prospects for fulfillment of the deficit criteria are generally deteriorating. But more importantly, recent events have highlighted the fundamental Franco-German dissent on the principal notion of EMU. In this respect, the stability pact reached at the Dublin EU summit, and the associated public statements of French officials, have served as a wake-up call for many German illusionists.

So far, any attempt at a serious, open-minded discussion of European monetary issues has been stifled in Germany by the automatic accusation that EMU opposition is nationalistic and anti-European. We have called this "Euroterrorism." Thus, the entire German establishment has been persuaded to remain quiet. Only a few outsiders dare to dispute the single currency. But now the French have been so kind as to deliver a target that every right-minded German can shoot at without qualms. That is the overt French effort to subordinate the supposedly sovereign European Central Bank to the will of a political council.

As Alain Juppé, the French Prime Minister, recently told the *Financial Times*: "We don't want all decisions on economic, budgetary, fiscal and monetary policy to be shaped by a technocratically-driven, semi-automatic system under the sole authority of the European Central Bank. That is not our concept of democracy." French President Jacques Chirac, in turn, blurted out during a television interview that he saw the single currency "as a means to fight against the dollar" – this goal, of course, to be pursued by fostering a weak, not a strong, Euro.

We are happy that at long last the silence in Germany about EMU has been broken. However, we must express our amazement at those Germans who profess to have belatedly discovered the existence of a fundamental difference in purpose between France and Germany. The truth is that German and French intentions were miles apart from the very beginning of this dubious project, guaranteeing the ultimate emergence of serious frictions.

German politicians portray EMU as an essential and consistent step towards an ultimate, grand political goal: the creation of a federal European state. Most probably, they believe this. It certainly is the primary motivation for that part of the German public which supports EMU. As to the common currency itself, the ostensible arguments for it amount to little more than mystic claims that the Euro will bring great, if unspecified, economic and political

benefits. As the same time, it is intimated that Germany owes it to the long-suffering French to abandon the monetary hegemony of the Bundesbank.

We regularly ask ourselves: Who exactly among the French need to be so pacified? Our answer can be derived from Bernard Connolly's book, *The Rotten Heart of Europe*: "For the French elite, money is not the lubricant of the economy but the most important lever of power. Capture of the Bundesbank is thus, for them, the great prize in the European monetary war. To secure it, they have been willing to tempt Germany with the lure of political union, while never intending to deliver it."

In short, for the French elite EMU is a struggle for power – not a quest for economic efficiency or European federalism. The French have discovered that in the modern world, monetary clout is a more reliable instrument of power than even the nuclear *force de frappe*. While this bid for French glory might placate the ghosts of Napoleon and De Gaulle, we find little in it of the lofty dreams of European brotherhood laid down in the Maastricht Treaty.

CONCLUSIONS

The driving force behind the dollar's recent sharp rise is the belief that the U.S. economy is surging, while the Japanese and German economies are struggling. The latter view is correct; the former is certainly wrong. For reasons explained, the fourth-quarter spurt of U.S. GDP was more a statistical fluke than a sign of sustainable strength.

Because the biggest distortion in the statistics arose from the U.S. trade figures, the dollar benefited disproportionately. We, on the other hand, expect a renewed widening of the U.S. trade deficit in 1997, even though domestic demand already is slowing. There is no self-feeding economic upturn in Europe or Japan to counteract this trend. Monetary looseness in those countries is insufficient to offset negative structural forces.

The major issues for the U.S. economy are the ongoing consumer retrenchment and the flattening of business profits. A sustained economic slowdown keeping monetary policy on hold is positive for the financial markets. But progressive profit erosion threatens the stock market.

Heightened volatility warns that the U.S. equity market has entered a more dangerous phase. It recently has become routine for the cash market to trade for most of the day in a reasonable manner, until in the final hour computer-driven program sales or purchases by aggressive derivatives operators swing the market for quick profits. This is a clear sign that the market has fallen under the sway of the most speculative of short-term traders. In Wall Street's cliché: Stocks are moving from strong hands to weak ones. Extreme caution is advised.

The dollar appears to be in the late stage of its cyclical advance. As it becomes clearer that the U.S. economy is slowing, rather than accelerating, the greenback will enter a substantial decline.

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